In the Supreme Court of the United States

OCTOBER TERM, 1967

No. 1014

FEDERAL OIL COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

Petitioner had been a wholesale gasoline distributor since 1937. In 1956 and 1957, it formed wholly-owned subsidiaries for the purpose of engaging in the retail fuel oil business. Subsequently, in 1959, petitioner, its subsidiaries, and its major stockholders entered into a written agreement with Sinclair Refining Company for the sale of the retail fuel oil business, together with all physical assets and good will related thereto. The agreement included the covenants of all vendors not to compete with Sinclair for five years. The total purchase price was $1,000,000. After considerable negotiation it was expressly allocated in the agreement as follows: $640,000 to the physical assets, $310,000 to the covenants not to compete, and $50,000 to good will (Pet. 3–4).

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Sinclair claimed a deduction based on amortization over a five-year period of the amount apportioned to the covenants. Petitioner, however, reported the entire amount allocated to the covenant as long-term capital gain from the sale of good will. The Commissioner issued a notice of deficiency based on the view that the amount the agreement apportioned to the covenant was ordinary income.[1]

In a resulting suit for redetermination the Tax Court ruled in favor of the Commissioner, holding that "Where, as here, the taxpayer enters into an agreement which has been the subject of arm's-length negotiations, freely, willingly and knowingly, we are not inclined to rewrite the agreement into one which the parties themselves would not have transacted" (Pet. App. 21a). The United States Court of Appeals for the Third Circuit, in affirming the decision of the Tax Court, restated the rule which it had earlier adopted in *Commissioner* v. *Danielson,* 378 F. 2d 771, 775, certiorari denied, 389 U.S. 858. It held (Pet. 2a):

> "[A] party can challenge the tax consequences of his agreement as construed by the Commissioner only by adducing proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc." No such proof has been offered or adduced in the instant case.

[1] There is no dispute that an amount received in consideration of such a covenant is ordinary income. See, *e.g.*, *Ullman* v. *Commissioner*, 264 F. 2d 305 (C.A. 2).

This rule is consistent with positions expressed by other circuits in comparable circumstances, and is not in conflict with decisions of this Court. There is no occasion for further review.

1. Petitioner's arguments here are for the most part the same as those advanced in the petition for certiorari in *Danielson* v. *Commissioner, supra,* No. 382, this Term. For our answers to those contentions we refer the Court to our opposition in that case.[2]

2. Here, as in *Danielson,* petitioner argues (Pet. 12–16) that Section 7453 of the 1954 Code and *Landa* v. *Commissioner,* 211 F. 2d 46 (C.A.D.C.), forbid the application of the parol evidence rule to bar the introduction of extrinsic evidence to modify the express terms of a written contract. As we pointed out in *Danielson,* the defect in this argument is that the parol evidence rule is one of substance, whereas Section 7543 relates only to questions of evidence.

Petitioner apparently concedes that the parol evidence rule is a rule of substantive law, but contends that the "stranger exception" to the rule provides a rule of evidence that should allow him to vary the allocation expressed in the contract with Sinclair (Pet. 14). An exception would be no more a rule of evidence than is the parol evidence rule itself. In addition, petitioner's argument that a written agreement creates no substantive rights as between a contracting party and a stranger thereto has no relevance here. The Commissioner is merely seeking to determine the tax consequences of the rights of the contracting parties estab-

[2] Copies of that opposition are being served on petitioner's counsel.

lished among themselves. Since petitioner, in an action involving only the parties to the contracts, could not introduce extrinsic evidence in an attempt to show that the consideration paid for the covenant was less than the stated amount, such evidence may not be introduced in an action brought by one of the contracting parties against the Commissioner. See *Clark* v. *United States*, 341 F. 2d 691, 693 (C.A. 9) (quoting from 9 Wigmore on *Evidence* (3d ed.), Section 2446); *Pugh* v. *Commissioner*, 349 F. 2d 76, 79 (C.A. 5); *United States* v. *Stallard*, 273 F. 2d 847 (C.A. 4); *Commissioner* v. *Dwight's Estate*, 205 F. 2d 298 (C.A. 2), certiorari denied, 346 U.S. 871; *Funk* v. *Commissioner*, 185 F. 2d 127 (C.A. 3). See, also, 3 Corbin on *Contracts* (1960), Section 596; 3 Jones on *Evidence* (2d ed.), Section 1489; 4 Williston on *Contracts* (3d ed., Jaeger), Section 647.

3. This case is even less appropriate for review in this Court than *Danielson*. In each case the taxpayer argued in the Tax Court that there was "strong proof" that the express allocation of part of the purchase price to the covenant not to compete failed to reflect the substance of the agreement. In *Danielson* the Tax Court found there was such "strong proof" and held for the taxpayer; the Third Circuit reversed. Here, in contrast, the Tax Court held for the Commissioner, finding that petitioner failed to introduce "strong proof" that the agreement differed in reality from the written expression thereof; the Third Circuit affirmed.[3]

[3] Thus, unlike petitioners in *Danielson*, petitioner here is not entitled to a remand (see Pet. 11–12).

Specifically, the Tax Court held that "the written agreement in the instant case realistically reflects the negotiations of the parties" (Pet. 22a). From the outset of the negotiations, Sinclair demanded an agreement not to compete, and petitioner agreed.[4] Even were this Court to disagree with the reasoning of *Danielson*, it would avail petitioner nothing unless it could show clear error in the Tax Court's assessment of the record. This, plainly, it cannot do.[5]

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[4] The Tax Court found that (Pet. 20a):

> In the instant case, the covenant not to compete was a subject of negotiation from the earliest discussions which resulted in the agreement of sale between Sinclair and petitioner, its wholly-owned subsidiaries, and the Singers. Sinclair consistently insisted upon a noncompete agreement and the allocation of a substantial portion of the purchase price to the covenant. During the course of the negotiations Sinclair's tax manager explained to Singer, who represented petitioner in the negotiations, that that portion of the purchase price allocated to the covenant not to compete would be taxable to petitioner as ordinary income. * * *

[5] As noted above, Sinclair amortized the amount allocated to the agreement not to compete over the five-year life of the covenant. Pending the final outcome of this case, the Commissioner has tentatively questioned Sinclair's treatment of the payments. Petitioner contends (Pet. 12) that this action has a deleterious effect on the administration of the tax laws and was not considered or referred to by the Third Circuit in *Danielson*. The questioning of Sinclair's treatment of the payments made pursuant to the agreement not to compete was necessary to protect the revenue because of the inconsistent tax treatment accorded the payment by each of the parties thereto. The point was considered by the Third Circuit in *Danielson*. See 378 F. 2d at page 778. Where such inconsistent positions are taken, the Commissioner recedes on the question as to one taxpayer, once the courts uphold the government's position as to the other.

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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